

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Third Party Communication: None
Date of Communication: Not Applicable

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CASE-MIS No.: TAM-104692-09

Chief, Appeals Office

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No.:
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =
State A =

ISSUES:

1. May the Taxpayer () accrue and deduct in the taxable year annual dividends on an insurance policy that, under the terms of the policy, become payable during the first month of the succeeding taxable year?
2. May the Taxpayer accrue and deduct in the taxable year the lesser of (1) the termination dividend that will be payable in the succeeding taxable year if the policy is terminated, or (2) the annual dividend that will be payable in the succeeding taxable year if the policy is not terminated?
3. If the Taxpayer may properly accrue and deduct the dividends described in Issues 1 or 2 in the year prior to the year the dividends become payable under the terms of

the policies, did the Taxpayer properly implement this change in its method of accounting?

CONCLUSIONS:

1. The Taxpayer may not accrue and deduct in the taxable year annual dividends on an insurance policy that, under the terms of the policy, become payable during the first month of the succeeding taxable year.
2. The Taxpayer may not accrue and deduct in the taxable year the lesser of the termination dividend or annual dividend that, under the terms of the policy, become payable in the succeeding taxable year.
3. Because we conclude that the Taxpayer may not accrue and deduct in the year preceding payment the dividends described in Issues 1 or 2 above, this issue is moot.

FACTS:

The Taxpayer is organized and existing under the laws of State A. The Taxpayer uses an overall accrual method of accounting for federal income tax purposes and computes its taxable income on a calendar year basis.

The Taxpayer issues “participating” life insurance policies that entitle policyholders to receive two types of dividends: annual dividends and termination dividends. An annual dividend is payable to each policyholder on the anniversary date of his or her policy, and represents a share of the Taxpayer’s divisible surplus earned from business operations during the preceding calendar year. A termination dividend is a one-time dividend payable to certain policyholders when the policy terminates due to the death of the insured or the maturity or surrender of the policy. It is a dollar amount that is based on factors such as the age of the policyholder and the number of years the policy was in force. A policyholder can receive both an annual dividend and a termination dividend in the year the policy terminates.

The Taxpayer accrues and deducts on December 31st of each taxable year the amount of the annual dividends that will become payable on policies with anniversary dates in January of the following year. The Taxpayer contends that this accrual is appropriate because the Taxpayer “posts”, or credits, the amount of the annual dividend to policyholder accounts up to days prior to the anniversary date of the policy. For policies with anniversary dates in January, the Taxpayer’s posting practice results in a posting of the dividend to policyholder accounts in December of the preceding year.

The taxpayer also accrues a deduction on December 31st of each taxable year for certain policies that, if terminated, would be eligible for a termination dividend in the following year. The amount of this deduction is the lesser of (1) the amount of the

termination dividend payable if the policy terminates during the following year, or (2) the amount of the annual dividend payable on the anniversary date of the policy if the policy does not terminate in the following year. The taxpayer contends that this accrual is appropriate because, as of December 31st of the taxable year, the Taxpayer has a fixed obligation to pay some minimum amount in the following taxable year: either an annual dividend if the policy remains in force until the anniversary date, or a termination dividend if it does not.

Declaration and Payment of Annual Dividends

Each _____, the Taxpayer's Board of Directors reviews management's estimate of the amount of divisible surplus for the taxable year that is available for the payment of dividends. The Board sets aside these amounts for the payment of dividends and authorizes management to pay annual dividends on policies that are in full force on their anniversary dates in the following year, provided that premiums on those policies have been paid in full to those anniversary dates. The Board also authorizes management to mail dividend notices to policyholders for dividends to be paid in the following year. In _____ of the following year, the Board ascertains the actual divisible surplus earned by the Taxpayer through December 31st of the preceding year. The Board formally appropriates the surplus for the payment of annual dividends.

The insurance policies provide: “

_____.” However, the Taxpayer's practice during all relevant years is to post (credit) the dividend to the policyholder's account on the later of (1) the date the required premium to the next anniversary date is received or (2) _____ days before the anniversary date. In the case of a paid-up policy with an anniversary date in January, the Taxpayer credits the policyholder with an annual dividend amount on or before the preceding December 31st.

Under the Taxpayer's practice, once an annual dividend has been credited to a policyholder's account, the status of the policy as of the anniversary date will not affect the policyholder's entitlement to the dividend. The Taxpayer has procedures in place that ensure that the policy stays in force until the anniversary date in all cases. If a policyholder requests a surrender of a policy, the Taxpayer delays processing the surrender for _____ days and seeks to discourage the policyholder from terminating the policy. After the expiration of the _____-day period, the Taxpayer further delays the processing of the surrender if the policy is within _____ days of an anniversary date. In this way, the policy is kept in force long enough to receive the annual dividend amount on the January policy anniversary. Thus, whether the policyholder surrenders the policy, dies before the anniversary date, or holds the policy until the anniversary date, the Taxpayer's practice is to pay or credit the annual policy dividend amount to the policyholder.

It also is the Taxpayer's practice to pay posted annual dividends up to days prior to the anniversary, if the policyholder requests this early payment. The Taxpayer's procedure manual explains how a policyholder may obtain an early payment of a dividend and this information is provided to the Taxpayer's insurance agents who can implement a policyholder request for an early payment of a dividend. The Taxpayer does not communicate this option to its policyholders directly.

Declaration and Payment of Termination Dividends

In _____, the Taxpayer's Board of Directors authorizes management to pay termination dividends that become due in the following year. The following _____, the Board appropriates an amount for the payment of termination dividends estimated to be due during the year.

The insurance policies themselves do not contain any reference to termination dividends. However, information regarding these dividends is available to agents through other sources, such as the Taxpayer's web site. These dividends are payable on the termination date of certain "legacy" life and endowment policies that are in force at least _____ years, where the policy holder is a minimum age. For example, on certain policies, a _____ year old policyholder will be eligible for a termination dividend after the policy is _____ years in force, while a _____ year old policy holder may not be eligible for a termination dividend until the policy is _____ years in force. The amount of the termination dividend increases slowly (increasing by as little as _____ per thousand face amount per year) as the policy ages, and reaches a maximum amount around the _____ year of the policy.

LAW AND ANALYSIS:

Statutory and Regulatory Framework

Section 808(c) provides that the deduction for policyholder dividends for any taxable year shall be an amount equal to the policyholder dividends paid or accrued during the taxable year. Life insurance companies are required to compute their income and deductions under an accrual method of accounting. § 811(a).

Section 1.461-1(a)(2)(i) of the Income Tax Regulations provides that under an accrual method of accounting, a liability (as defined in §1.446-1(c)(1)(ii)(B)) is incurred, and generally is taken into account for federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

Section 1.461-4(g) provides guidance with respect to certain liabilities for which payment is economic performance (i.e. payment liabilities). Section 1.461-4(g)(1)(i) provides, in part, that in the case of liabilities described in paragraphs (g)(2) through (g)(7) of this section, economic performance occurs when and to the extent that payment is made to the person to which the liability is owed.

Section 1.461-4(g)(3) provides that if the liability of a taxpayer is to pay a rebate, refund, or similar payment to another person (whether paid in property, money, or as a reduction in the price of goods or services to be provided in the future by the taxpayer), economic performance occurs as payment is made to the person to which the liability is owed. This paragraph applies to all rebates, refunds, and payments or transfers in the nature of a rebate or refund regardless of whether they are characterized as a deduction from gross income, an adjustment to gross receipts or total sales, or an adjustment or addition to cost of goods sold.

Section 1.461-4(g)(7) provides that in the case of a taxpayer's liability for which economic performance rules are not provided elsewhere, economic performance occurs as the taxpayer makes payments in satisfaction of the liability to the person to which the liability is owed.

Section 1.461-5(a) provides a "recurring item" exception to the economic performance requirements. Except as otherwise provided in paragraph (c) of § 1.461-5, a taxpayer using an accrual method of accounting may adopt the recurring item exception as a method of accounting for one or more types of recurring items incurred by the taxpayer.

Section 1.461-5(b) provides that a liability is treated as incurred for a taxable year if -

(i) As of the end of that taxable year, all events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy;

(ii) Economic performance with respect to the liability occurs on or before the earlier of

(A) The date the taxpayer files a timely (including extensions) return for that taxable year; or

(B) The 15th day of the 9th calendar month after the close of that taxable year;

(iii) The liability is recurring in nature; and

(iv) Either –

(A) The amount of the liability is not material; or

(B) The accrual of the liability for that taxable year results in a better matching of the liability with the income to which it relates than would result from accruing the liability for the taxable year in which economic performance occurs.

Section 1.461-5(b)(5)(ii) provides that in the case of a liability described in § 1.461-4(g)(3) (rebates and refunds), the matching requirement of § 1.461-5(b)(1)(iv)(B) is deemed satisfied.

Section 1.461-5(b)(3) provides that a liability is recurring if it can generally be expected to be incurred from one taxable year to the next. However, a taxpayer may treat such a liability as recurring in nature even if it is not incurred by the taxpayer in each taxable year. In addition, a liability that has never previously been incurred by a taxpayer may be treated as recurring if it is reasonable to expect that the liability will be incurred on a recurring basis in the future.

Section 1.461-5(c) provides that the recurring item exception does not apply to any liability of a taxpayer described in paragraph (e) (interest), paragraph (g)(2) (workers compensation, tort, breach of contract, and violation of law), or paragraph (g)(7) (other liabilities) of § 1.461-4.

The “All Events” Test

A liability must be final and definite in amount, must be fixed and absolute, and must not be conditional to satisfy the all events test for federal income tax purposes. United States v. Hughes Properties, Inc., 476 U.S. 593, 600-601 (1986). The all events test is based on the existence or nonexistence of legal rights or obligations at the close of a particular accounting period, not on the probability – or even absolute certainty – that such right or obligation will arise at some point in the future. United States v. General Dynamics Corp., 481 U.S. 239, 243-4 (1987); Brown v. Helvering, 291 U.S. 193, 200-201 (1934). “It is fundamental to the all events test that, although expenses may be deductible before they have become due and payable, liability must first be firmly established.” General Dynamics, 481 U.S. at 243. See also Rev. Rul. 2007-3, 2007-1 C.B. 350. Generally, all events have occurred that establish the fact of the liability when (1) the event fixing the liability, whether that be the required performance or other event, occurs, or (2) payment is unconditionally due. Rev. Rul. 2007-3, citing Rev. Rul. 80-230, 1980-2 C.B. 169, and Rev. Rul. 79-410, 1979-2 C.B. 213.

Issue 1: Annual Dividends on Policies with January Anniversary Dates

The terms of a contract are relevant in determining the events that establish the fact of a taxpayer's liability. Rev. Rul. 2007-3, citing Decision, Inc. v. Commissioner, 47 T.C. 58 (1966), acq., 1967-2 C.B. 2. As a rule, in the absence of clear evidence that the parties agreed otherwise, the terms bargained for by the parties to the contract control. Ullman v. Commissioner, 264 F.2d 305 (2nd Cir. 1959). Under the terms of the policies here, annual dividends are payable on the anniversary date of the policy, provided the policy is then in force and all premiums due have been paid to the anniversary date. The requirement that the policy be paid up on its anniversary date is a condition precedent to Taxpayer's liability to pay the annual dividend. The last event fixing the Taxpayer's liability is the policy being in force on the anniversary.

The Taxpayer states that its liability for policyholder dividends with anniversary dates in January should be treated as fixed in December because the taxpayer's *practice* is to post, or credit, annual dividends up to days in advance of the anniversary date and to pay the dividends up to days prior to the anniversary date if the policyholder requests. If a policyholder attempts to surrender the policy within this day period, it is the taxpayer's *practice* to delay the processing of that request to keep the policy in force to the anniversary date at which time the annual dividend is paid. In effect, the taxpayer argues that its *practice* abrogates the terms of the policy.

We disagree. The terms of the policy (*contract* between the parties), rather than the Taxpayer's informal *practice*, should control. A taxpayer cannot fix its own liability simply by making an internal adjustment to its accounts – in this case, by “crediting” the January anniversary dividends by the end of December. See Commissioner v. The H.B. Ives Company, 297 F.2d 229 (2nd Cir. 1961) (citations omitted), cert. denied, 370 U.S. 904 (1962) (“Thus neither the resolution of respondent's board of directors, nor the entry on its books, in themselves establish the proper accrual of the claimed liability in 1953. Deduction could be claimed only when the liability to pay became certain.”); Goebel Brewing Company v. Commissioner, 43 T.C. 8, 15 (1964).

The taxpayer also states that State A law mandates that if any annual dividends are paid in advance (and some of the January annual dividends were occasionally paid in advance, even in the prior December) then all other policyholders in that class must receive the same amount and under the same terms. The taxpayer argues that the operation of state law prevents it from changing its crediting practice and thus fixes the Taxpayer's liability. We disagree. The law of State A does not itself establish a liability for the taxpayer. The liability is the result of the taxpayer's contract with its policyholders. All that the law of State A does is require similar treatment of similarly situated policyholders. That requirement can be met even with a change in the taxpayer's crediting practice.

The taxpayer's crediting practice is composed of two individual practices: (1) paying annual dividends up to days early if the policy is still in force and already paid up to the anniversary date; and (2) delaying the processing of termination requests

received within days of the anniversary date so that the policy remains in force on the anniversary date and the annual dividend can be paid on that date. With respect to the first practice, we do not dispute that once a policyholder with a January anniversary date has requested and received an annual dividend in December, any other policyholder with a January anniversary must have the ability to request and receive the annual dividend up to days early. That practice, however, does not fix the taxpayer's liability for the annual dividends credited to policyholders with January anniversary dates. The taxpayer is not liable for any of the early payments of annual dividends until a request for the early payment is made by a policyholder. That request for early payment is itself a condition precedent to its liability.

With respect to the second practice, we believe the taxpayer is free on December 31st, to change its practice of delaying the processing of termination requests received within days of the anniversary date. The point of that practice is to actually pay the annual dividend *on the anniversary date*. If, for anniversary dates beginning on January 1st, the taxpayer began enforcing the contractual requirement that the policy must be paid up and in force on the anniversary date to be eligible for the annual dividend, all policyholders with January anniversary dates would be treated the same with regard to this practice. No policyholder with a January anniversary date receives an annual dividend in December as a result of the taxpayer's practice of delaying requested policy surrenders to the anniversary date. Thus, there would be no prohibited discrimination between policyholders with January anniversary dates. Consequently, we believe the taxpayer is free to change this practice at the end of the year and its liability for the January dividends is not fixed at that point.

Our conclusion is supported by the statutory changes to § 808 over the last 25 years. The Deficit Reduction Act of 1984, P.L. 98-369 (July 18, 1984) ("DRA of 1984") changed the method of accounting for policyholder dividends from a reserve method to an accrual method of accounting. See Section 211 of DRA of 1984, reprinted in 1984-3 C.B. Vol. 1 227 et seq. In the legislative history to section 1821 of the Tax Reform Act of 1986, (a provision further modifying § 808) Congress concluded that the liability for policyholder dividends is only fixed in the year the policy remains in force and the dividend is unconditionally due under the contract and must be paid. S. Rep. No. 313, 99th Cong., 2d Sess. 965-6 (1986), reprinted in 1986-3 C.B. Vol. 3 965-6.

Congress specifically considered insurance companies' practice of accelerating dividend deductions by guaranteeing policy dividends on termination or by making policy dividends available upon declaration. Congress rejected this practice because they viewed it as the equivalent of the impermissible reserve method. Congress described how the accrual method applies to policyholder dividends like those of the Taxpayer as follows:

The "fresh start" was granted with respect to the accounting change for policyholder dividends on the assumption that the insurance

companies would continue to follow their general business practice in declaring policy dividends at the end of the calendar year to be payable on policy anniversaries during the following calendar year only in the event the policy remained outstanding on such anniversary. *It was understood that, given the general business practices, the present law-change in policyholder dividends accounting had the effect of delaying the deduction for policyholder dividends to the taxable year in which they were paid.*

S. Rep. No. 313, 99th Cong., 2d Sess. 965-6 (1986), reprinted in 1986-3 C.B. Vol. 3 965-6 (emphasis added). See also General Explanation of the Revenue Provisions of the Tax Reform Act of 1984 (Blue Book), prepared by the Staff of the Joint Committee on Taxation 610 (1984).

Clearly, Congress did not intend to permit taxpayers to accelerate the deduction of policy dividends to years prior to the year the dividend is payable under the terms of the policy.

Issue 2: Accrual of the Lesser of Next Year's Termination Dividend or Annual Dividend

The Taxpayer argues that at the end of the year, it has a fixed obligation to pay either an annual dividend in the next year or a fixed obligation to pay a termination dividend in the next year: in either case, a minimum amount of dividend will be paid. The Taxpayer is “aggregating” two different liabilities to argue that it has a fixed amount at year end to be paid in the following year. Essentially, the Taxpayer wants to treat termination dividends as a subcomponent of annual dividends. We do not agree that these separate potential obligations can be integrated into a single fixed obligation.

Annual dividends are calculated based on a variety of factors, including the business operations of the Taxpayer, experience-rated refunds, excess interest, and premium adjustments. Annual dividends provided for in the contracts are to be paid if the contract is in force and fully paid up on the anniversary date. A customer has election options in applying the annual dividend. The annual dividend occurs regularly over the course of a policyholder's contract.

In contrast, a termination dividend is a one-time payment made only in the year that a policyholder terminates the contract. Unlike annual dividends that are paid under the terms of the *contract*, termination dividends are not provided for in the contract with a policyholder. Termination dividends are a matter of informal company *practice*. Under the taxpayer's published procedures (but not in the policy contract), a policyholder is eligible for a termination dividend only after holding the policy for years and only if certain age requirements are met. Furthermore, the termination dividend scale does not change annually (), indicating the “one-time” component of termination dividends. After the policyholder has held the

policy for over years, the termination dividend ceases to increase from year to year and becomes a flat amount.

The obligation to pay annual dividends in the following year is based on whether the policy is in force on the anniversary date and whether the premiums are paid up until that date. At the stroke of midnight at year end, it is not yet known or knowable whether an annual dividend will be paid to a policyholder, as it is not known or knowable whether the policyholder will maintain the policy as required until the anniversary date.

Likewise, it is not known or knowable whether any one policyholder will terminate prior to the anniversary date, thus triggering the Taxpayer's obligation to pay a termination dividend. At midnight at year end, it is not known or knowable if a termination dividend will be required.

Consequently, the last event fixing the obligation to pay either an annual dividend or a termination dividend does not occur until after year end: the last event is either (1) the continuation of the policy until the anniversary date when payment is then required under the terms of the policy contract or (2) the cancelling of the policy such that a termination dividend might be paid under the business practice of the Taxpayer. See Brown v. Helvering, 291 U.S. at 359-60 ("But no liability accrues during the taxable year on account of cancellations which it is expected may occur in future years, since the events necessary to create the liability do not occur during the taxable year.")

A single liability can have a minimum amount owed at year end, even where a different and greater amount is owed in the following year. Hughes Properties., 476 U.S. at 604. Such minimum amount, if it satisfies the all-events test, permits the liability to be fixed and the amount therefore deductible. For example, under a plan whereby the employer, using the accrual method of accounting, is obligated to pay to its employees at least two percent but not more than three percent of the company's profits for a taxable year as bonuses, but under which the exact percentage cannot be determined until after the close of such year, such bonuses are accruable and allowable as a deduction only to the extent of the "fixed" two percent of the company's profit for such year. The portion of the bonuses paid in the following taxable year in excess of the "fixed" two percent is deductible in that year. Rev. Rul. 61-127, 1961-2 C.B. 36. Cf. Valero Energy Corporation v. Commissioner, 78 F.3d 909 (5th Cir. 1996) (taxpayer argued it had two separate obligations regarding stock, while the court found a single obligation; because of the single obligation, the taxpayer could not take a second deduction in a later year).

Even assuming the liability here is fixed, the Taxpayer does not meet the economic performance prong of the all events test. The liability here is a "payment liability" within the meaning of § 1.461-4(g). Economic performance generally is met for a payment liability when payment is made to the person to whom the liability is owed, unless the taxpayer meets the recurring item exception. Because the Taxpayer seeks

to accrue the liability in the year *preceding* payment, Taxpayer's ability to meet the economic performance requirement hinges on whether the recurring item exception applies.

The recurring item exception generally applies to the specifically enumerated payment liabilities listed in § 1.461-4(g). The exception does not apply to the non-enumerated "other liabilities" described in § 1.461-4(g)(7). See § 1.461-5(c). In our view, the dividend obligation here cannot properly be characterized as one of the specifically enumerated payment liabilities. We conclude that it is an "other liability" described in § 1.461-4(g)(7).

The Taxpayer argues that the liability here is a rebate, refund or similar payment specifically enumerated in § 1.461-4(g)(3). We do not agree. Nothing in the insurance policies characterizes either annual dividends or termination dividends as rebates, refunds, or anything similar. An annual dividend is a participation in the earned surplus of the Taxpayer. Termination dividends are not provided for by the policies, and nothing the Taxpayer has provided indicates that these dividends are rebates or refunds.

Issue 3: Change in Method of Accounting

Based on our conclusions with respect to Issues 1 and 2, Issue 3 is moot.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.